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TAGS: ECON EFIN ELAB PGOV IT KPRP
SUBJECT: ITALY'S BUDGET: SQUEEZED BY ELECTION-YEAR SPENDING
AND EU AUSTERITY COMMITMENT

REF: A. ROME 27
¶B. 2005 ROME 3697

Introduction, Summary, and Comment

¶1. On December 22, Parliament approved the 2006 budget which includes euro 27.5 billion in spending cuts and new revenue measures to shrink the deficit/GDP ratio to 3.8 percent (Italy's EU ceiling for 2006). Italy's budget process faced the double pressure of EU deficit ceilings, and front-loaded election-year spending.

¶2. On defense, spending as a percentage of GDP amounts to 0.90 percent, down from 0.99 percent. The budget mandates a 5.1 percent nominal cut from 2005 levels, but funding for existing multi-year programs and investments remains about the same. Specifically, the 2006 budget includes a nominal 55 million euros a year through 2020 (or, a nominal 825 million a year over fifteen years) for &Major International and Interforce Programs.8 However, procurement programs not already under contract, such as the Joint Surveillance and Command Program (JSCP) and C-17, may be at risk.

¶3. On peace-keeping (a separate line item from defense), the budget appropriates one billion euro, down 20 percent from 2005; and on foreign assistance, 400 million euro, down 28 percent from 2005. Italy's high-priority assistance to Afghanistan, however, will remain uncut in FY 2006.

¶4. Because of front-loaded spending (or, &pork8) this year before the April elections, the European Stability Pact requirement to keep the budget deficit below the 3.8 percent of GDP-ceiling will mean the new Government will be faced with a fiscal balancing act in 2006.

¶5. In sum, Italy is scrimping to meet its international obligations (on foreign assistance and defense), continues to over-rely on undependable tax amnesty proceeds, has taken some steps to curb spending, but has not mustered the political courage before an election year to make the necessary structural changes, especially on pensions and wages.

¶6. Next steps: On January 12, the European Commission will review the euro 27.5 billion budget package to see if the numbers are real and if budget reduction measures (either budget cuts or revenue-generating measures) are bona fide (long-term) structural measures, or one-off measures, not always guaranteed to generate savings or revenue. End Introduction, Summary, and Comment.

Nibbling at the Deficit...

¶7. The bill includes 15.9 billion euro in spending cuts, including 9.8 billion euro from central government administration and 6.1 billion euro cuts in regional/local government transfers. The Finance Ministry explains the transfer cuts as a continuation of the 2005 budget strategy to cut all government spending. In particular, some public-sector wages will be capped; Members of Parliament will take a ten percent pay cut. While all GOI Ministries and administrations will be affected, cuts affect only discretionary spending, not guaranteed employee salary and benefits.

But There Is New Spending.

¶8. The budget also contains 3.3 billion euro in new spending programs: inter alia, family support (1.2 billion euro), public-sector wage increases (0.6 billion euro), and pension measures (0.3 billion euro).

Some New Revenue and Another Tax Amnesty

¶9. The budget provides for new revenue of 7.3 billion euro, mostly from increased business and real estate taxes and reduced tax deductions.

¶10. The budget also includes a tax amnesty, despite Finance Minister assurances there would be no further recourse to this flawed, one-off deficit reduction measure. The latest amnesty permits recalcitrant firms and self-employed to pay only a percentage of delinquent 2003-2004 taxes and to pay a percentage of taxes due in advance for the next three years in lieu of regular annual tax returns.

¶11. Both tax amnesties would net three billion euro. This is one budget measure the EU Commission will review in January.
¶12. Finally, the budget also includes a 25-percent &porno-tax8 on income from pornographic material production and distribution.

Postponing Lisbon-Fund Commitments Till 2007?

¶13. The 2006 budget authorizes raising three billion euro through real estate sales and privatizations to support Italy,s reforms under the EU Lisbon Agenda to make the EU (and Italy) more competitive and knowledge-driven. In view of Italy,s budgetary difficulties, Italy may shift its program to 2007.

Military Funding: Peacekeeping Cut, but Only on Paper.
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¶14. Peacekeeping mission funding is not a part of defense operations funding and is carried as a separate line item apart from the budget. In 2006, the deficit reduction package) on paper -- cuts peacekeeping funding for all peacekeeping missions, including to Iraq, from 1.25 billion euro in 2005 to 1.0 billion in 2006. However, since peacekeeping funding is authorized every six months through a decree law, the GOI could make up for a mid-year funding shortage by a decree law then transferring funds from other miscellaneous line items in the general budget (ref B).

Defense Operations Funding

¶15. Defense funding (MOD budget, net of domestic security/law enforcement, or Carabinieri, expenditures) will decrease from 13.6 billion euro in 2005 to 12.9 billion euro in 2006, or by 5.1 percent. As percentage of GDP, 2006 defense funding, as defined just above, amounts to 0.90 percent of GDP, compared to 0.99 percent in 2005. To minimize the 2006 reduction,s impact on defense operations, the GOI last October approved a decree law to, inter alia, authorize the sale of 968 million euro in MOD real estate in 2006. The 12.9 billion euro figure does not include the hypothetical real estate sale proceeds because the Finance Ministry has now earmarked them for debt reduction.

¶16. On multi-year programs and investments, funding remains just about the same. The defense budget figure of 12.9 billion euro does include 55 million this year for MOD &Major International and Interforce Programs.8 (Funding will continue at this amount through 2020.) However, procurement programs not already under contract, such as the Joint Surveillance and Command Program (JSCP) and C-17 may be at risk this year.

¶17. The 2006 Ministry of Productive Activities budget also allocates an additional 1.9 billion euro for technological innovation, managed by this Ministry, and of which some is available to private firms conducting defense research. (This figure is not included in the para 14 defense funding figure.)

¶18. For the Italian-French multi-mission frigate program (FREMM), the 2006 Ministry of Productive Activities budget allocates 30 million euro for 2006, 30 million euro for 2007, and 75 million euro for 2008. These amounts fund Italy,s obligation to the program and are carried in the Productive Activities Ministry budget and are not considered part of &Major International and Interforce Programs.8

Foreign Assistance

¶19. Foreign assistance will decline 27.6 percent, from 552.6 million euro in 2005, to 400 million euro in 2006. FY 2006 foreign assistance represents 0.3 percent of GDP, down from 0.4 percent in 2005. Adding 2006 foreign assistance to official (e.g., Paris Club) debt relief totals 0.12 percent of GDP (short of the 0.7 percent Monterrey Conference target and the 0.36 percent EU average). While it is unclear where cuts will be made, we do know there will be major cuts to NGO support. (Comment, as reported Ref A Italy's Special Envoy for Afghanistan, Anna della Croce, told Charge January 3 that Italy will not cut its approximately 50 million euro in

Afghan assistance already pledged for 2006. End Comment.)

April Elections Could Mean Early Spending Spree.
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¶20. While politicians have made strong denials that the budget contains election-year pork, most expect the ruling conservative coalition to front load budget expenditures (especially public works and tourism promotion) to build support in the run-up to April national elections. This strategy would mean that the winning coalition may need to implement a supplemental revenue package (e.g., tax and fee increases or more tax amnesties) or severely cut spending after elections to keep the budget deficit below the Stability Pact 3.8 percent of GDP ceiling. Otherwise, Italy will again find itself in hot water with the EU for its excessive deficit.
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